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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 769

WAYNE HUGH EASLEY TRUST, W. H. EASLEY, TRUSTEE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ROGER KENT EASLEY TRUST, W. H. EASLEY, TRUSTEE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 72–79) are reported at 21 T. C. 51. The opinion of the Court of Appeals (Pet. App. i–xii) is reported at 228 F. 2d 810.

JURISDICTION

The judgment of the Court of Appeals was entered on December 22, 1955. (Pet. App. xiii.) The petition for a writ of certiorari was filed on March 16, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether the courts below erred in holding that interest received by the taxpayer-trusts on account of overpayments of income taxes constituted taxable income of the trusts, not of the settlors.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> (26 U. S. C. 1952 ed., Sec. 22.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(2) *Non-trade or non-business expenses.*—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and

originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

* * * * *

(26 U. S. C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> SEC. 29.22 (a)–1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * * In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

STATEMENT

The facts of this case, all of which were stipulated, may be summarized as follows:

Taxpayer trusts were created on October 1, 1940, by W. H. Easley and Margaret A. Easley, husband and wife. The trusts kept their books and filed their income tax returns on the cash method of accounting and on the calendar year basis. From the date of their creation and during the period involved, 1940–1945, taxpayers have existed as trusts under and by virtue of the laws of the State of California. W. H. Easley has

been the duly qualified and acting trustee of taxpayer trusts. (Pet. App. i–ii.)

Prior to October 1, 1940, W. H. Easley and Margaret A. Easley conducted a business of bottling and selling a beverage known as "Seven-Up" under a franchise from the Seven-Up Company of St. Louis, Missouri. The business (hereinafter called the Bottling Company) was conducted at San Francisco, California, and was known as the Seven-Up Bottling Company of San Francisco. (Pet. App. ii.)

Pursuant to declarations of trust on October 1, 1940, Easley and his wife, as settlors, each transferred an undivided one-fourth interest in their business, the Bottling Company, to W. H. Easley, as trustee of taxpayer trusts. The settlors filed gift tax returns and paid deficiencies in gift tax determined by the Commissioner. For each of the years 1940 through 1945, a partnership return of income was filed in the name of the Bottling Company in which the settlors and taxpayer trusts were named as partners and one-fourth of the net income of the Bottling Company was reported as the respective share of each of these partners. Each taxpayer trust reported its share of the net income in its tax returns for the years involved. (Pet. App. ii–iii.)

In 1947, the Tax Court determined that all of the income of the Bottling Company was taxable to the settlors Easley and his wife as their community income. Accordingly, deficiencies in tax

and interest were assessed against the settlors and overassessments of tax and credits for interest thereon were determined for taxpayer trusts for the taxable years 1940 through 1945. Pursuant to a "consent to credit" for each of the years involved, executed by W. H. Easley, trustee, the Collector of Internal Revenue applied the overassessments of tax with respect to taxpayer trusts in reduction of the deficiencies assessed against the settlors. Notices and demands for the remaining balance of the deficiencies plus interest were issued to the settlors. (Pet. App. iii–iv.)

During the year 1948, the Collector mailed to taxpayer trusts checks covering the interest allowed on the overassessments for the taxable years 1940 through 1945. Easley, as trustee, endorsed such interest checks and he and his wife, as settlors, used the funds in part payment of the deficiencies in interest assessed against them. The aggregate amount of the checks mailed to taxpayer trusts during 1948, covering interest on the overassessments for the years 1940 through 1945, was $27,842.05 for taxpayer Wayne Hugh Easley Trust and $27,517.65 for taxpayer Roger Kent Easley Trust. (Pet. App. iv.)

For the year 1948, taxpayer trusts excluded the total amounts of interest checks received on the overassessments in computing gross income. The Commissioner, in determining taxpayer trusts' income tax liability for the year 1948, added the amount of such interest checks to each

taxpayer trust's net income disclosed by its return. (Pet. App. iv.)

The settlors, Easley and his wife, on their 1948 income tax returns, deducted, as interest paid on the deficiencies resulting from the taxation to them of the net income reported by taxpayer trusts, the interest deficiencies assessed against them, reduced by the amount of the interest checks received by taxpayer trusts. The Commissioner increased their respective deductions for interest by the amount of the interest checks. (Pet. App. v.)

The Tax Court sustained the Commissioner's determination, holding that the interest paid to the trusts was includible in the gross income of the trusts under Section 22 (a) of the Internal Revenue Code of 1939, and was not deductible by reason of having been paid over to the settlors. (R. 77–79.) The Court of Appeals affirmed, one judge dissenting. (Pet. App. i–xii.)

ARGUMENT

The courts below were clearly correct in agreeing with the Commissioner that the interest on the overpayments was taxable to the taxpayer trusts, which had made the overpayments and which received the interest checks, notwithstanding the assignment of the interest to the settlors. As petitioners recognize (Pet. 14), there is no conflict; and there is no other reason for further review by this Court.

Section 22 (a) of the Internal Revenue Code of 1939, *supra*, defines gross income as including "interest" received, regardless of its source. A trust is of course a taxable entity separate and distinct from the settlor and the beneficiaries. Interest received by a trust because of an overpayment of tax made out of the trust funds is no less includible in the trust's taxable income than any other interest received for the use of the trust's funds. As the court below stated (Pet. App. vi), "No distinction is made [in Section 22 (a)] as to interest of any source, whether it be earned because of overassessment of taxes or from investments made with the earning of interest specifically in mind." That the trusts chose to assign their right to collect the interest, by endorsing the interest checks to the settlors, no more served to relieve them of income tax than any other assignment of income. *Helvering* v. *Horst*, 311 U. S. 112.

Petitioners contend (Pet. 15) that the trusts were not taxable on the interest in question on the theory that they were obligated under equitable principles to "restore" the interest to the settlors. In effect petitioners argue that because the partnership income which the settlors donated to the trusts remained taxable to and should have been reported by the settlors individually, any separate additional income realized by the trusts from the use of the trust funds (i. e., the donated partnership income) must also be treated as tax-

able to the settlors, not to the trusts. Petitioners cite no authority to support their theory, and both courts below properly rejected it. While the partnership income was taxable to the settlors, the trusts nevertheless acquired ownership of it by gift from the settlors; any income which that income in turn produced was taxable to its owners, the trusts. Nothing in the trust instruments or elsewhere warrants the assumption that the donee-trusts were required to return the donated partnership income to the donor-settlors merely because it turned out that the settlors remained taxable on the income,[1] nor is there any claim that the trusts did so. And since the trusts were not obliged to return the partnership income itself, *a fortiori* they were not required to pay over the interest received for the use of that income. Had the trusts invested the partnership income in interest-bearing securities, the interest received unquestionably would have been taxable to the trusts notwithstanding that the partnership income itself was taxable to the settlors. See *Schreiber* v. *Commissioner*, 6 T. C. 707, af-

[1] The most that could be said in petitioners' favor is that the settlors' transfer of the partnership interest to the trusts was made under a mistake of law, *i. e.*, on the assumption that the partnership income would be taxable to the trusts for federal income tax purposes. Under the applicable California law this would constitute insufficient ground for revoking the trusts. See *Wingerter* v. *San Francisco*, 134 Cal. 547; *Cooley* v. *County of Calaveras*, 121 Cal. 482; *Benson* v. *City of Long Beach*, 61 Cal. App. 2d 189; *Campbell* v. *Rainey*, 127 Cal. App. 747.

firmed, 160 F. 2d 108 (C. A. 6th). The interest received from the Government on account of an overpayment of tax by the trusts stands on no different footing.

Equally untenable is the petitioners' alternative contention (Pet. 15) that, if the interest received is includible in the trusts' 1948 gross income under Section 22 (a), a like amount is deductible by the trusts in the same year, either as an expense under Section 23 (a), *supra,* or as interest paid under Section 23 (b), *supra.* This argument rests essentially on the mistaken proposition that the trusts were legally obligated to pay over the interest to the settlors immediately upon its receipt. As both courts below pointed out (R. 78; Pet. App. x), the record fails to establish the existence during the taxable year 1948 (or for that matter, at any other time) of any such obligation. Moreover, even assuming that the trusts or their beneficiaries might in some subsequent year be adjudged liable in an adversary proceeding to turn over the interest to the settlors, that still would not justify deduction of the interest in 1948. Having applied for and received the interest in 1948 under a claim of right, the trusts were taxable on the income in that year, even though they might later be held liable to disgorge it. *Healy* v. *Commissioner,* 345 U. S. 278; *North American Oil* v. *Burnet,* 286 U. S. 417.

In short, petitioners' arguments miss the plain and decisive point that settlor and trust are

separate taxable entities, and that the overpayments which gave rise to the interest payments in this case were made by the trusts out of trust funds. The overpayments having been made by the trusts, the refunds and interest belonged to and were payable to them, not to some other taxpayer. Indeed, the Commissioner has no authority to credit one taxpayer's overpayment and interest against another's tax liability (*Hart Glass Mfg. Co.* v. *United States*, 48 F. 2d 435 (C. Cls.), certiorari denied, 286 U. S. 556), although he may—as he did here—allow the credit with the consent of the parties (*Daube* v. *United States*, 289 U. S. 367). Petitioners' attempt, which they recognize as novel (Pet. 14), to alter the rules governing this familiar problem presents no occasion for review by this Court.

CONCLUSION

It is respectfully submitted that the petition for a writ of certiorari should be denied.

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